Supreme Court, U.S.
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No.

In the Supreme Court of the United States

SECURITIES AND EXCHANGE COMMISSION, PETITIONER

v.

CHARLES E. EDWARDS

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE ELEVENTH CIRCUIT

PETITION FOR A WRIT OF CERTIORARI

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QUESTION PRESENTED

Whether the court of appeals erred in dismissing the complaint on the ground that an investment scheme is excluded from the term "investment contract" in the definitions of "security" in Section 2(a)(1) of the Securities Act of 1933, 15 U.S.C. 77b(a)(1), and Section 3(a)(10) of the Securities Exchange Act of 1934, 15 U.S.C. 78c(a)(10), if the promoter promises a fixed rather than variable return or if the investor is contractually entitled to a particular amount or rate of return.

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PETITION FOR A WRIT OF CERTIORARI

The Solicitor General, on behalf of the Securities and Exchange Commission (SEC or Commission), respectfully petitions for a writ of certiorari to review the judgment of the United States Court of Appeals for the Eleventh Circuit in this case.

OPINIONS BELOW

The opinion of the court of appeals (App., *infra*, 1a-15a) is reported at 300 F.3d 1281. The order of the district court (App., *infra*, 16a-27a) granting the Commission's motion for a preliminary injunction is reported at 123 F. Supp. 2d 1349.

JURISDICTION

The judgment of the court of appeals was entered on August 6, 2002. A petition for rehearing was denied on

November 15, 2002 (App., *infra*, 28a-29a). The jurisdiction of this Court is invoked under 28 U.S.C. 1254(1).

STATUTES INVOLVED

The texts of 15 U.S.C. 77b(a)(1) and 78c(a)(10) are reproduced in Appendix D, *infra*, 30a-31a.

STATEMENT

1. The definitions of "security" in Section 2(a)(1) of the Securities Act of 1933 (Securities Act), 15 U.S.C. 77b(a)(1), and Section 3(a)(10) of the Securities Exchange Act of 1934 (Exchange Act), 15 U.S.C. 78c(a)(10), include not only conventional securities, such as "stock[s]" and "bond[s]," but also the broader term "investment contract." The Court explained in *Reves* v. *Ernst & Young*, 494 U.S. 56, 61 (1990), that, because "Congress' purpose in enacting the securities laws was to regulate *investments*, in whatever form they are made and by whatever name they are called," Congress crafted "a definition of 'security' sufficiently broad to encompass virtually any instrument that might be sold as an investment."

In keeping with that broad definition, the Court has held that an "investment contract" means "a contract, transaction or scheme whereby a person invests his money in a common enterprise and is led to expect profits solely from the efforts of the promoter or a third party." *SEC* v. *W.J. Howey Co.*, 328 U.S. 293, 298-299 (1946) (*Howey*). The Court has stressed that the term "investment contract" "embodies a flexible rather than a static principle, one that is capable of adaptation to meet the countless and variable schemes devised by those who seek the use of the money of others on the promise of profits." *Id.* at 299. Accord *SEC* v. *C.M. Joiner Leasing Corp.*, 320 U.S. 344, 351 (1943) (*Joiner*).

2. Respondent Charles E. Edwards was the founder, chairman, chief executive officer and sole owner of ETS Payphones, Inc. (ETS). App., *infra*, 2a; Exh. 20, at 25, 31; 10/12/00 Tr. 17, 58. In order to obtain financing from the public to operate its business, ETS, under respondent's direction, offered and sold interests consisting of a payphone, a leaseback/management agreement, and a buyback agreement. App., *infra*, 2a-3a, 17a; Exh. 18, at 5-8; Exh. 20, at 33-35. Specifically, investors bought payphones for up to $7000 each from an ETS subsidiary and leased them back to ETS for five years for fixed payments of $82 per month per phone (approximately a 14% return) regardless of the profitability of the phone. App., *infra*, 17a-18a; Exh. 14; Exh. 18, at 5-6. As part of the lease agreement, ETS promised to refund the full purchase price of each payphone at the end of the lease or within 180 days of the investor's request. App., *infra*, 17a; Exh. 14; Exh. 15, at 11. ETS chose the locations for the payphones and managed and maintained them; investors never saw the phones and often did not know where they were located. App., *infra*, 17a, 22a; Exh. 20, at 94-95.

ETS marketed its payphone investments over the internet and through a network of independent distributors. App., *infra*, 17a; Exh. 20, at 42-48. Promotional brochures and materials on the web sites portrayed the company and its management as experienced and successful in the telecommunications industry, touted the profitability of the payphone industry, and exhorted prospective investors to "watch the profits add up." App., *infra*, 17a-18a; Exh. 15, at 9; Exh. 17, at 8. The ETS program was described as "virtually recession-proof," providing a "steady, immediate cash flow," easily liquidated, and suitable for retirement accounts. Exh. 15, at 5, 8, 12; Exh. 17, at 5. As a result of that

marketing, ETS took in approximately $300 million from more than 10,000 investors in 38 States. See App., *infra*, 3a; Compl. 1.

Although the sales literature and web sites presented ETS as a profitable company, in fact, the opposite was true: ETS was never profitable. App., *infra*, 18a, 24a; Exh. 1, at 4-6. Because revenue from payphone operations fell short of the amount needed to meet rental payments to investors, ETS used funds from new investors to pay existing investors. App., *infra*, 18a, 24a; Exh. 1, at 6; 10/12/00 Tr. 41. ETS had an operating loss of more than $42 million in 1999 and more than $33 million for the first six months of 2000. Exh. 1, at 4; 10/12/00 Tr. 39-40. In September 2000, ETS filed for bankruptcy protection. App., *infra*, 19a.

Respondent was aware of the financial condition of ETS, including the fact that the company was dependent on funds from new investors to sustain its operations. App., *infra*, 19a, 25a; 10/12/00 Tr. 59-60. Respondent nonetheless failed to disclose to investors ETS's true financial condition; nor did he disclose that the company could not honor its commitment to repurchase investors' phones if a significant number of them exercised their buyback option. Exh. 6, at 2; 10/12/00 Tr. 59-60. Indeed, in a communication as late as July 2000, only two months before the bankruptcy filing, he reassured investors of ETS's financial stability and asserted that the company made a profit of nearly $9 million in 1999. Exh. 23, at 2; see App., *infra*, 25a ("Despite [his] knowledge, [respondent] marketed the program as a profitable enterprise 'ringing with opportunity.'").

Despite ETS's consistent losses, respondent personally profited. App., *infra*, 18a. Respondent drained approximately $18 million from the company in direct compensation, management fees, and interest-free

loans to other companies he controlled. *Ibid.*; 10/12/00 Tr. 44-45, 64-65, 68-69.

3. In September 2000, the SEC brought this civil law enforcement action against respondent and ETS in the United States District Court for the Northern District of Georgia. The SEC alleged that, by carrying out the payphone investment scheme, respondent and ETS violated the registration requirements of Section 5(a) and (c) of the Securities Act, 15 U.S.C. 77e(a) and (c), and the antifraud provisions of Section 17(a) of the Securities Act, 15 U.S.C. 77q(a), and Section 10(b) of the Exchange Act, 15 U.S.C. 78j(b), and Rule 10b-5 thereunder, 17 C.F.R. 240.10b-5. Compl. 9-12. The Commission sought a permanent injunction against future violations of the registration and antifraud provisions, disgorgement of ill-gotten gains with prejudgment interest, and civil penalties. *Id.* at 12-16.[1]

The Commission moved at the outset of the case for preliminary relief. Following an evidentiary hearing, the district court found that the SEC had made a prima facie showing that respondent had committed the alleged violations, and the court granted the Commission's request for preliminary relief against him. App., *infra*, 16a-27a.[2]

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[1] The registration provisions of the Securities Act require the filing of a registration statement, and the delivery to investors of a prospectus, containing information about the company, including financial statements. See 15 U.S.C. 77f, 77g(a), 77j, and Schedule A, Items 25 and 26. The registration provisions are enforceable both by the government and through private actions. See 15 U.S.C. 77t, 77*l*(a)(1).

[2] ETS itself, without admitting or denying the allegations of the Commission's complaint, consented to a preliminary injunction. App., *infra*, 16a. ETS later consented to a permanent injunction.

The district court found that the payphone sale/leaseback/buyback arrangement was an "investment contract" under the federal securities laws. App., *infra*, 17a-23a. The court applied the test for an investment contract set forth in *Howey*, 328 U.S. at 298-299, which the Eleventh Circuit has characterized as having three elements: "(1) an investment of money; (2) a common enterprise; and (3) the expectation of profits to be derived solely from the efforts of others." App., *infra*, 19a (quoting *Villeneuve* v. *Advanced Bus. Concepts Corp.*, 698 F.2d 1121, 1124 (1983), aff'd en banc, 730 F.2d 1403 (11th Cir. 1984)). The district court found that participants in the scheme had made "an investment of money." *Ibid.* The court also found a "common enterprise," because recovery of the investments "depend[ed] upon the financial viability of [ETS] and [its] ability to generate a profit." *Id.* at 21a. Finally, the court found that the investors expected profits from ETS's efforts rather than their own, because they had relinquished "all responsibility for the payphones" to respondent and ETS, who "monitored, managed, and maintained" the phones. *Id.* at 22a.

After determining that the payphone arrangement was an investment contract, the district court concluded that the SEC had established a prima facie case that respondent violated the registration requirements of the Securities Act by selling "unregistered securities to thousands of people in thirty-eight states." App., *infra*, 23a. The district court also found that the SEC had established a prima facie case that respondent committed fraud in connection with the sale of securities because "investors were led to believe that both ETS

SEC v. *ETS Payphones, Inc.*, No. 00-CV-2532 (N.D. Ga. entered Jan. 14, 2002) (Docket Entry No. 157).

and its payphone program generated a profit" while "ETS had failed to make a profit," "was losing money on its payphone program," and "depended on funds from new investors in order to sustain operations." *Id.* at 24a. Concluding that the SEC was likely to succeed on the merits, the court entered a preliminary injunction against future violations of the registration and antifraud provisions of the securities laws and froze respondent's assets to the extent that they were not subject to the bankruptcy proceedings involving ETS and its subsidiaries. *Id.* at 26a-27a.

4. In a per curiam opinion, the United States Court of Appeals for the Eleventh Circuit reversed the district court's judgment and ordered the dismissal of the SEC's complaint for lack of subject matter jurisdiction under the federal securities laws. App., *infra*, 1a-15a. The court of appeals held that the payphone sale/leaseback/buyback scheme did not involve an "investment contract." *Id.* at 4a-8a.

The court acknowledged that "an investment of money is apparent" in the scheme (App., *infra*, 5a) and that ETS investors purchased the payphone packages "for the purpose of earning a return on the purchase price" (*id.* at 6a). The court concluded, however, that the SEC could not show "that investors who contracted with ETS expected profits to be derived solely through the efforts of others." *Ibid.*

The court understood the decision in *United Housing Foundation, Inc.* v. *Forman*, 421 U.S. 837, 852 (1975), to have limited the scope of "profits" under *Howey* to "capital appreciation" or "a participation in earnings" of the enterprise. App., *infra*, 6a. The court of appeals held that the monthly payments that ETS investors received were not a participation in ETS's earnings be-

cause they were "fixed" amounts, rather than amounts that varied according to the earnings of ETS. *Id.* at 7a.

The court of appeals also held that, even if the monthly payments could be considered profits, they were not "derived solely from the efforts of others." App., *infra*, 7a. The court reasoned that "the determining factor is the fact that investors were entitled to their lease payments under their contracts with ETS." *Id.* at 8a. Because their returns were thus "contractually guaranteed," the court held, "those returns were not derived from the efforts of [respondent] or anyone else at ETS; rather, they were derived as the benefit of the investors' bargain under the contract." *Ibid.*

Because the court of appeals concluded that investors in the ETS payphone scheme did not expect profits derived from the efforts of others, the court found it unnecessary to determine whether there was a "common enterprise" as described in *Howey*. App., *infra*, 5a-6a. Judge Lay, however, filed a concurring opinion addressing that issue. *Id.* at 9a-15a.

The court of appeals subsequently denied the SEC's petition for rehearing and rehearing en banc. App., *infra*, 28a-29a.

REASONS FOR GRANTING THE PETITION

This case involves a nationwide fraudulent scheme that promised investors a high rate of return on their money with no effort on their part. The constricted interpretation of the term "investment contract" adopted by the court of appeals erroneously excludes those investors from the protections of the Securities Act and the Exchange Act and opens a seemingly limitless gap in the protection that those Acts provide against securities fraud. An investment is not precluded from being an "investment contract" because the promised

return is fixed rather than variable or because the return is "contractually guaranteed." The contrary decision of the court of appeals is a significant and unwarranted departure from the flexible definition of "investment contract" that this Court has consistently applied in *Howey*, *Joiner*, and other cases, based on the broad language of the Acts and the congressional intent manifested by that language. The decision of the court of appeals conflicts with decisions of at least two other courts of appeals: *SEC* v. *Infinity Group Co.*, 212 F.3d 180 (3d Cir. 2000), cert. denied, 532 U.S. 905 (2001), and *United States* v. *Carman*, 577 F.2d 556 (9th Cir. 1978). The court of appeals' decision also conflicts with the interpretation of the federal securities laws reflected in formal adjudicatory opinions and other statements of the SEC. If allowed to stand, the decision will significantly impair the Commission's ability to enforce the securities laws for the protection of investors. This Court's review is therefore warranted.

1. The court of appeals erred in holding that an investment cannot be an "investment contract" if the return is fixed rather than variable or if the investor is contractually entitled to a particular amount or rate of return. Those restrictions are unsupported by the text of the securities laws, undermine Congress's goal of comprehensive protection for investors, and depart from the flexible definition of "investment contract" consistently applied by this Court.

a. As this Court has repeatedly stressed, the text of the federal securities laws defines "security" in the broadest terms. See 15 U.S.C. 77b(a)(1), 78c(a)(10) (reproduced at App., *infra*, 30a-31a). "Congress' purpose in enacting the securities laws was to regulate *investments*, in whatever form they are made and by whatever name they are called." *Reves*, 494 U.S. at 61.

Congress determined that the best way to achieve its goal of protecting investors was "to define 'the term "security" in sufficiently broad and general terms so as to include within that definition the many types of instruments that in our commercial world fall within the ordinary concept of a security.'" *Forman*, 421 U.S. at 847-848 (quoting H.R. Rep. No. 85, 73d Cong., 1st Sess. 11 (1933)).

In order to craft "a definition of 'security' sufficiently broad to encompass virtually any instrument that might be sold as an investment," *Reves*, 494 U.S. at 61, Congress included in the definition not just "standardized" instruments, such as stocks and bonds, but also "investment contracts." *Joiner*, 320 U.S. at 351. Congress included that "general descriptive designation[]" to ensure the comprehensiveness of the Acts' coverage, which "does not stop with the obvious and commonplace" but includes "[n]ovel, uncommon, or irregular devices" that are offered as investments. *Ibid.*

Nothing in the term "investment contract" suggests that the term is limited to an arrangement promising a variable return or a return that is not "contractually guaranteed" (*i.e.*, not specified or promised as an entitlement in a contract).[3] Invest means "to lay out

[3] A true "guaranty" is a promise by a third party to pay the debt or otherwise perform the obligation of the principal promisor in the event of nonpayment or other nonperformance by the principal promisor. See *Black's Law Dictionary* 634 (5th ed. 1979). There was no such "guaranty" here (although, even if there were, that would not mean the arrangement was not an investment contract). The court of appeals used the term "contractually guaranteed" more loosely, as a shorthand description of the fact, recited in the preceding sentence, that "investors were entitled to their lease payments under their contracts with ETS." App., *infra*, 8a. Thus, the court apparently used the term merely to indicate that

(money or capital) in business with the view to obtaining an income or profit," and investment is the "investing of money or capital in some species of property for income or profit." *Webster's New International Dictionary* 1306 (1934); see *Webster's Third New International Dictionary* 1190 (1993) ("an expenditure of money for income or profit or to purchase something of intrinsic value"). Neither "income" nor "profit" necessarily connotes a variable (rather than fixed) return or a return that is not promised by contract. See *Webster's New International Dictionary*, *supra*, at 1258, 1976; *Webster's Third New International Dictionary*, *supra*, at 1143, 1811. Moreover, a contract is "[a]n agreement between two or more persons to do or forbear something." *Webster's New International Dictionary*, *supra*, at 578; accord *Webster's Third New International Dictionary*, *supra*, at 494. Thus, the very term "investment contract" itself contradicts any notion that instruments of that name cannot include investments in which the return is promised by one party to the contract.

Further, as this Court noted in *Howey*, the term "investment contract" had a well-established meaning under cases construing the state Blue Sky laws that predated the federal securities laws. 328 U.S. at 298. State cases established that an investment contract meant "a contract or scheme for 'the placing of capital or laying out of money in a way intended to secure income or profit from its employment.'" *Ibid.* (quoting *State* v. *Gopher Tire & Rubber Co.*, 177 N.W. 937, 938 (Minn. 1920)). That definition, which includes both

the amount or rate of return was specified or otherwise expressly promised in the contract. This brief uses the term in the same sense as the court of appeals.

"income" and "profit" and was "broadly construed by state courts so as to afford the investing public a full measure of protection" (328 U.S. at 298), is clearly expansive enough to include an investment having a fixed or guaranteed return. Indeed, two of the state cases cited by this Court in *Howey* to illustrate the meaning of "investment contract" involved fixed or contractually guaranteed returns. See *People* v. *White*, 12 P.2d 1078 (Cal. Dist. Ct. App. 1932) (return of $7500 on investment of $5000); *Stevens* v. *Liberty Packing Corp.*, 161 A. 193, 195 (N.J. Ch. 1932) ("guaranteed" return amounting to $56 per year on investment of $175).

The role of the term "investment contract" in the statutory definitions of security confirms that the term includes an agreement providing for a fixed or guaranteed return. Congress included the term "investment contract" as a catch-all for unusual investments that cannot be categorized as one of the standardized instruments included in the definitions. See p. 10, *supra*; *Golden* v. *Garfalo*, 678 F.2d 1139, 1144 (2d Cir. 1982). Several of the conventional instruments enumerated in the definitions of security are debt securities that traditionally yield a fixed return, *e.g.*, "bond" and "debenture," 15 U.S.C. 77b(a)(1), 78c(a)(10), and that return is typically promised ("guaranteed") in the instrument itself. Moreover, the definition of security in the 1933 Act expressly includes a "guarantee of" any of the other enumerated items. 15 U.S.C. 77b(a)(1). Because the specific securities listed in the definitions of security include investments having returns that are fixed and contractually guaranteed, it makes sense that the catch-all term "investment contract" should also include such investments. See *Wals* v. *Fox Hills Dev. Corp.*, 24 F.3d 1016, 1018 (7th Cir. 1994) (purpose of

"the term 'investment contract'" is to identify "unconventional instruments that have the essential properties of a debt or equity security").

By excluding investments with fixed or contractually promised returns from the catch-all category of "investment contract," the court of appeals' decision opens an immense loophole in the definition of security. A promoter who seeks to obtain capital to operate a business enterprise could avoid the coverage of the securities laws simply by offering contracts that promise a fixed or specified return rather than provide more generally for a return that varies with the earnings of the enterprise. Those who perpetrate fraudulent investment schemes frequently promise fixed or guaranteed returns, and such promises are particularly attractive to the elderly or unsophisticated investors most likely to fall victim to such fraud. The large gap in the coverage of the securities' laws that results from the court of appeals' decision therefore frustrates Congress's goal of ensuring comprehensive protection for investors by "regulat[ing] *investments*, in whatever form they are made and by whatever name they are called." *Reves*, 494 U.S. at 61. Because investments include interests yielding fixed and contractually promised returns, it makes no sense to exclude such interests from the scope of "investment contract."

b. In engrafting rigid, technical limits onto the broad language used by Congress, the court of appeals also departed from the flexible definition of "investment contract" consistently applied by this Court. In *Howey*, the Court adopted the broad definition of "investment contract" under the state Blue Sky laws, which the Court paraphrased as "a contract, transaction or scheme whereby a person invests his money in a common enterprise and is led to expect profits solely from

the efforts of the promoter or a third party." *Howey*, 328 U.S. at 298-299. The Court noted that this definition is "flexible" and "capable of adaptation to meet the countless and variable schemes devised by those who seek the use of the money of others on the promise of profits." *Id.* at 299. The Court stressed that, in applying the definition, the emphasis is on "economic reality" and the substance of the transaction rather than its form. *Id.* at 298. The Court further cautioned that "[t]he statutory policy of affording broad protection to investors is not to be thwarted by unrealistic and irrelevant formulae." *Id.* at 301.

Applying that flexible approach, the Court in *Howey* concluded that the investments at issue—fee simple interests in orange groves packaged with service contracts to cultivate the land, sell the fruit for the investor, and remit to him any profit—were investment contracts. 328 U.S. at 300. The Court cited (*id.* at 299 n.5) a variety of cases, including a formal adjudication by the Commission, in which "transactions which, in form, appear to involve nothing more than the sale of real estate, chattels, or services, have been held to be investment contracts where, in substance, they involve the laying out of money by the investor on the assumption and expectation that the investment will return a profit without any active effort on his part." *In re Natural Res. Corp.*, 8 S.E.C. 635 (1941). The Court explained that it is "immaterial whether the shares in the enterprise are evidenced by formal certificates or by nominal interests in the physical assets employed in the enterprise" (*Howey*, 328 U.S. at 299), even if the "tangible interest which is sold has intrinsic

value independent of the success of the enterprise as a whole" (*id.* at 301).[4]

In concluding that the orange grove scheme involved an investment contract, the Court in *Howey* relied on the fact that investors did not expect to use the land themselves but were "attracted solely by the prospects of a *return* on their investment" (328 U.S. at 300 (emphasis added)), but the Court did not concern itself with whether the anticipated return was fixed or variable, contractually promised or unspecified. On the contrary, the Court stated that, in determining whether an investment contract is involved, "it is immaterial whether the enterprise is speculative or non-speculative." *Id.* at 301.

Although the definition that the Court adopted used the term "profits," as noted above, that term is not limited to variable or unspecified returns. Rather, the Court made clear that the term "investment contract" in the federal securities laws was intended to have the same meaning that it had been given under the state Blue Sky laws, which used the even broader phrase

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[4] In the half century since *Howey*, the courts of appeals have continued to find such schemes to be investment contracts. See *Blackwell* v. *Bentsen*, 203 F.2d 690 (5th Cir. 1953) (citrus groves), cert. dismissed, 347 U.S. 925 (1954); *Continental Mktg. Corp.* v. *SEC*, 387 F.2d 466 (10th Cir. 1967) (beavers), cert. denied, 391 U.S. 905 (1968); *Kemmerer* v. *Weaver*, 445 F.2d 76 (7th Cir. 1971) (beavers); *Glen-Arden Commodities, Inc.* v. *Costantino*, 493 F.2d 1027 (2d Cir. 1974) (whiskey); *Miller* v. *Central Chinchilla Group, Inc.*, 494 F.2d 414 (8th Cir. 1974) (chinchillas); *Smith* v. *Gross*, 604 F.2d 639 (9th Cir. 1979) (earthworms); *United States* v. *Jones*, 712 F.2d 1316, 1321-1322 (9th Cir.) (truck trailers), cert. denied, 464 U.S. 986 (1983); *Albanese* v. *Florida Nat'l Bank*, 823 F.2d 408 (11th Cir. 1987) (ice machines); *Long* v. *Shultz Cattle Co.*, 881 F.2d 129 (5th Cir. 1989) (cattle); *Bailey* v. *J.W.K. Prop., Inc.*, 904 F.2d 918 (4th Cir. 1990) (cow embryos).

"income or profit." See p. 11, *supra*. And the Court cited with approval not only the two state cases involving fixed or guaranteed returns described above, but also an SEC injunctive action in which the investment contract promised a fixed return. See *Howey*, 328 U.S. at 299 n.5 (citing *SEC* v. *Universal Serv. Ass'n*, 106 F.2d 232, 237-238 (7th Cir. 1939), cert. denied, 308 U.S. 622 (1940)). Thus, the ETS scheme fits squarely within *Howey*'s understanding of an investment contract.

The Court also took a flexible approach to the definition of "investment contract" in *Joiner*. There the Court held that assignments of oil leases, sold in a nationwide campaign that promoted them as investments and "assured [potential investors] that the Joiner Company was engaged in and would complete the drilling of a test well * * * to test the oil-producing possibilities of the offered leaseholds," were securities in the form of investment contracts. 320 U.S. at 346. The Court reasoned that whether an investment contract is involved turns on "what character the instrument is given in commerce by the terms of the offer, the plan of distribution, and the economic inducements held out to the prospect." *Id.* at 352-353. "In the enforcement of an act such as this," the Court stressed, "it is not inappropriate that promoters' offerings be judged as being what they were represented to be." *Id.* at 353. The Court took the same approach in *SEC* v. *United Benefit Life Insurance Co.*, 387 U.S. 202 (1967), which held that investments in certain annuity products that were promoted as a means of achieving financial "'growth' through sound investment management" were investment contracts. *Id.* at 211.

Viewed in light of the promoter's representations, as in *Joiner* and *United Benefit*, the ETS arrangement is

plainly an investment contract. Respondent consistently marketed the ETS arrangement as an "investment" opportunity that would provide "profits." See App., *infra*, 17a-18a; Exh. 14, at 1, 2; Exh. 15, at 5, 7, 8, 9; Exh. 17, at 4, 5, 8, 9, 10, 11; Exh. 22, at 1, 5. The lure that ETS' promotional materials held out to prospective investors—the expectation of a high return on their money from a profitable company in a profitable industry, with no effort expended by the investors themselves—readily fits within the *Howey* definition of investment contract.[5]

c. The court of appeals mistakenly concluded (App., *infra*, 6a-7a) that the scope of the "profits" component of the *Howey* definition had been narrowed by a statement in this Court's decision in *Forman*. In *Forman*, the Court, in describing its holdings in prior investment contract cases, stated: "By profits, the Court has meant either capital appreciation resulting from the development of the initial investment * * * or a participation in earnings resulting from the use of investors' funds." 421 U.S. at 852. Contrary to the interpretation of the court of appeals, *Forman*'s reference to "a participation in earnings" did not create a new test that

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[5] The Court has consistently followed the flexible approach illustrated by *Howey*, *Joiner*, and *United Benefit* in its other cases involving investment contracts. See *Marine Bank* v. *Weaver*, 455 U.S. 551, 555-556 (1982) (noting breadth of definition); *id.* at 556 (noting importance of how instrument is promoted); *Forman*, 421 U.S. at 848 (emphasizing importance of economic reality and substance rather than form); *id.* at 852 (stating that investment contract definition "embodies the essential attributes that run through all of the Court's decisions defining a security"); *Tcherepnin* v. *Knight*, 389 U.S. 332, 336 (1967) (emphasizing substance and economic reality rather than form); *id.* at 338 (reiterating that definition is "flexible" and "capable of adaptation").

narrowed *Howey* to variable return investments. The Court in *Forman* was simply describing one of its prior cases (*Tcherepnin* v. *Knight*, 389 U.S. 332 (1967)), and did not thereby hold that no other kind of return can constitute profits.

The basic point of the Court's reference in *Forman* to capital appreciation or a participation in earnings was to distinguish the situation in which an investor is "'attracted only by the prospects of a return' on his investment," which involves a security, from a situation in which "a purchaser is motivated by a desire to use or consume the item purchased," which does not involve a security. 421 U.S. at 852-853. Thus, in *Forman*, in which the Court held that stock entitling low-income purchasers to lease an apartment in a state-subsidized and supervised non-profit housing cooperative was not an "investment contract," the Court concluded that the purchasers "were attracted solely by the prospect of acquiring a place to live, and not by financial returns on their investments." *Id.* at 853. In this case, there is no question that investors in the ETS scheme were motivated by the prospect of a financial return rather than the desire for personal use of the telephones involved in the scheme.

Moreover, the Court made clear in *Forman* that "profit may be derived from the *income* yielded by an investment," 421 U.S. at 855 (emphasis added), and that the essence of the test is whether "the investor is 'attracted solely by the prospects of a *return*' on his investment," *id.* at 852 (emphasis added). The terms "income" and "return" are not limited to variable yields. See p. 11, *supra*; *Webster's New International Dictionary*, *supra*, at 2130; *Webster's Third New International Dictionary*, *supra*, at 1941. Nor is "a participation in earnings" limited to variable return investments. An

investor can have a "participation" in the "earnings" of an enterprise even when his return is not *measured* by those earnings. Irrespective of the *measure* of the return, an investor expects a "participation" in "earnings" when, as in this case, he is led to expect that the *source* of his return will be the company's earnings. Cf. *SEC* v. *Koscot Interplanetary, Inc.*, 497 F.2d 473, 485 (5th Cir. 1974) (describing fixed payments promised to investors for bringing in new investors as "a share in the proceeds" of the business).[6]

d. Nor is there anything in this Court's cases that supports the court of appeals' conclusion that profits that are "contractually guaranteed"—*i.e.*, expressed as an entitlement under a contract (App., *infra*, 8a)—are not expected to come "from the efforts of the promoter or a third party" (*Howey*, 328 U.S. at 299). Under *Howey*, the focus of the "efforts" element is not on whether profits are promised in the contract, but on whether the promoter, rather than the investors,

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[6] The *Howey* definition of investment contract also was not narrowed by this Court's characterization in *Reves* of the statement that the Court made in *Forman*. In *Reves*, the Court established the test for determining whether an interest denominated as a note is a security. In so doing, the Court concluded that the *Howey* test does not govern that question, and the Court stated that "the *Howey* test is irrelevant to the issue before us today." 494 U.S. at 64, 62 n.4. In describing the "irrelevant" *Howey* test, however, the Court (relying on *Forman*) stated that "profit," as used in that test, had been defined "restrictively" so that "a rate of interest not keyed to the earnings of the enterprise" would not constitute "profit." *Id.* at 68 n.4. The meaning of the *Howey* test was not, however, before the Court in *Reves*, and the Court therefore had no occasion to (and did not purport to) alter its meaning. The Court merely characterized how it believed *Forman* had interpreted the *Howey* test. As the discussion above illustrates, the Court's characterization of *Forman* (and *Howey*) was mistaken.

manages the enterprise that is expected to generate the profits. See 328 U.S. at 300 ("manage[ment] by [the promoters] or third parties with adequate personnel and equipment [was] essential if the investors [we]re to achieve their paramount aim of a return on their investments"). Here, the district court found that respondent "manage[d], maintain[ed], and operate[d] the pay phones" and that "investors retain[ed] little, if any, control." App., *infra*, 17a. The court of appeals did not conclude that that finding was clearly erroneous. Indeed, the court recognized that "the funds generated by the payphones helped ETS meet its [lease and buyback] obligations." *Id.* at 7a. Thus, the court erred in focusing on the fact that the investors' income or return was promised in the contracts, rather than on the fact that investors expected to receive their returns from the earnings generated by respondent's efforts in managing ETS.[7]

2. This Court's review of the erroneous decision of the court of appeals is warranted because the decision conflicts with decisions of at least two other courts of appeals. In *SEC* v. *Infinity Group Co.*, 212 F.3d 180 (2000), cert. denied, 532 U.S. 905 (2001), the Third Circuit expressly rejected the argument that the promise of a fixed return precludes an interest or arrangement

[7] Even if the court of appeals had been correct in its narrow interpretation of the term "investment contract," it still would have erred by ordering the dismissal of the Commission's complaint for lack of subject matter jurisdiction under the securities laws. The Commission argued in the district court that the investment instruments here also qualified as securities because they were "notes" or "evidences of indebtedness," and the court of appeals should have remanded for the district court to consider whether the case could proceed on one of those theories or any other theory.

from being an investment contract. Purchasers of Infinity's "property transfer contracts" transferred money to a trust to invest at the trustees' discretion. *Id.* at 184. As in the present case, participants were by "contract[]" "guaranteed" (*id.* at 187) a high, fixed rate of return (either 138% or 181%, depending on the amount invested) and repayment upon demand (*id.* at 184-185 & n.2). The *Infinity* defendants raised $26.6 million from 10,000 investors nationwide, but invested only $12 million of it, made no profits on the funds invested, and used the remainder of the funds for themselves. *Id.* at 185. Like respondent, the defendants in *Infinity* failed to disclose the enterprise's mounting losses or that they were using incoming funds from new investors to pay returns on earlier investors' funds. *Ibid.*

Notwithstanding the fixed and contractually guaranteed return, the Third Circuit held that the property transfer contracts "clearly constitute securities." 212 F.3d at 191. The court explained that

> the definition of security does not turn on whether the investor receives a variable or fixed rate of return. * * * The mere fact that the expected rate of return is not speculative does not, by itself, establish that the property transfer contracts here are not "investment contracts" within the meaning of [the] federal securities laws.

Id. at 189. The court concluded: "We will not embroider a loophole into the fabric of the securities laws by limiting the definition of 'securities' in a manner that unduly circumscribes the protection Congress intended to extend to investors." *Id.* at 191.

Similarly, in *United States* v. *Carman*, 577 F.2d 556 (1978), the Ninth Circuit held that an investment with a

fixed return and a true guaranty was an investment contract. The defendant in *Carman* sold a different asset than respondent—a federally insured student promissory note rather than a payphone—but, like respondent, he packaged that asset with a service contract and a repurchase agreement. *Id.* at 560. The *Carman* court held that "[t]he combination created * * * an integrated investment package which must be viewed in its entirety in determining whether it is within or without the Act." *Id.* at 564 (internal quotation marks and citation omitted). The court rejected the defendant's argument that the package could not be an investment contract "because the return was in the form of fixed interest, guaranteed by the federal government." *Id.* at 563. The court recognized that, despite the fixed return and federal guaranty, purchasers of the note packages remained subject to investment risk. The federal guaranty was conditioned on the defendant's "care and diligence" in "making and collecting on the notes." *Ibid.* Investors were therefore dependent on the defendant's sound management and continued solvency without which it would not be able to meet its obligations (*ibid.*), just as the investors in this case were dependent on ETS's continued solvency for ETS to be able to meet its lease-payment and repurchase obligations. The *Carman* court concluded that "this risk of loss is sufficient to bring the transaction within the meaning of a security, even where the anticipated financial gain is fixed." *Ibid.*

Other courts of appeals have also found instruments or schemes yielding a fixed or contractually guaranteed return to be investment contracts, albeit without directly addressing the arguments adopted by the court of appeals here. See, *e.g.*, *SEC* v. *SG Ltd.*, 265 F.3d 42, 51 (1st Cir. 2001) ("flat 10% guaranteed return"); *Gary Plastic Packaging Corp.* v. *Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 756 F.2d 230, 234 n.2 (2d Cir. 1985) (certificates of deposit paying fixed rates of between 12.55% and 14.60%); *SEC* v. *Professional Assocs.*, 731 F.2d 349, 351, 355, 357 (6th Cir. 1984) (units in escrow account earning "interest" and trust accounts paying 9% annually); *SEC* v. *Better Life Club of Am., Inc.*, 995 F. Supp. 167, 173-174 (D.D.C. 1998) (holding that purported "loans" promising fixed return to investor-lenders (double the money invested) were investment contracts), aff'd, 203 F.3d 54 (D.C. Cir.) (Table), cert. denied, 528 U.S. 867 (1999). See also *SEC* v. *Universal Serv. Ass'n*, 106 F.2d 232 (7th Cir. 1939), cert. denied, 308 U.S. 622 (1940). The results in those cases cannot be reconciled with the holding of the court of appeals in this case.

3. Review by this Court is also warranted because the Eleventh Circuit's decision conflicts with the SEC's longstanding interpretation of the securities laws, and, if allowed to stand, will significantly impair the Commission's ability to enforce those laws for the protection of investors. The SEC's view that an investment contract can include a fixed or contractually guaranteed return is embodied in at least two formal adjudications. In *In re Abbett, Sommer & Co.*, 44 S.E.C. 104 (1969), *available in* 1969 WL 95369, the Commission ruled that mortgage notes—which provide a fixed rate of interest as the return—were investment contracts when they were sold together with management services and a promise to repurchase the notes in the event of default. The Commission noted that the sales literature stressed "the 'guarantee' of the notes by" the company and concluded that the purchasers were "rel[ying] upon the services and undertakings of others to secure the return of a profit." 1969 WL 95359, at *3-*4. Similarly,

in *In re Union Home Loans*, 26 S.E.C. Dkt. 1517 (Dec. 16, 1982), *available in* 1982 WL 522493, the SEC held that promissory notes secured by deeds of trust on real property and sold with a package of management services were investment contracts. The Commission noted that the advertisements to potential investors stated "that investors will receive a specified percentage return on their investment depending upon the market at the time the loan is made" and that "[t]he return currently being offered is about 16 percent." 1982 WL 522493, at *2. The SEC's interpretation of the securities laws in those adjudications is entitled to deference under *Chevron U.S.A. Inc* v. *Natural Resources Defense Council, Inc.*, 467 U.S. 837 (1984). See *SEC* v. *Zandford*, 122 S. Ct. 1899, 1903 (2002) (citing *United States* v. *Mead Corp.*, 533 U.S. 218, 229-230 & n.12 (2001)).

The SEC has also taken the position in its briefs before this Court and in other official statements that "investment contracts" may offer fixed or contractually guaranteed returns. See, *e.g.*, Br. for the SEC as Amicus Curiae Supporting Pet'rs at 28, *Reves*, *supra* (No. 88-1480); *Public Offerings of Investment Contracts Providing for the Acquisition, Sale or Servicing of Mortgages or Deeds of Trust*, SEC Release No. 33-3892 (Jan. 31, 1958) (noting that an "[i]mplied or actual guarantee of specified yield or return" is indicative of an investment contract); *Multi-level Distributorships and Pyramid Sales Plans*, SEC Release Nos. 33-5211 & 34-9387 (Dec. 7, 1971) (stating that it is not "significant that the return promised for use of an investor's money may be something other than a share of the profits of the enterprise").

The SEC's position that an investment contract can include a fixed and contractually guaranteed return is

also reflected in numerous civil enforcement actions, including one prosecuted as early as 1936. In *SEC* v. *Universal Service Ass'n*, 106 F.2d 232 (7th Cir. 1939), cert. denied, 308 U.S. 622 (1940), the SEC brought a civil enforcement action for violations of the 1933 Act against various individuals, an association, and a corporation that sold investment contracts promising that, after five years, investors would receive their initial principal plus a 30% per annum return. See *e.g.*, *Los Angeles Trust, Deed & Mortgage Exch.* v. *SEC*, 285 F.2d 162 (9th Cir. 1960), cert. denied, 366 U.S. 919 (1961).

The Commission continues to bring many injunctive and administrative actions each year in which the schemes involve investment contracts promising fixed or guaranteed returns, including pay telephone sale/leaseback schemes like the one in this case. See, *e.g.*, *SEC* v. *Amtel Communications, Inc.*, 60 S.E.C. Dkt. 2080 (Nov. 7, 1995) ($51 per month lease payment). In fiscal year 2002 alone, the SEC instituted more than two dozen actions involving investment contracts offering fixed and contractually guaranteed returns. See, *e.g.*, *SEC* v. *Americash-Inc.com*, No. 02-80457 (S.D. Fla. compl. filed May 16, 2002) ("guaranteed" 36% return); *SEC* v. *U.S. Funding Corp.*, No. 2:02cv2089 (D.N.J. compl. filed May 2, 2002) ("guaranteed" return of 20% for one-year investment and 25% for two-year investment); *SEC* v. *Dunbar*, No. 02-233 (M.D. La. compl. filed Mar. 4, 2002) (return of $100,000 on investment of $200); *SEC* v. *CDH & Affiliates, Inc.*, No. 3:02cv00017 (N.D. Ga. compl. filed Feb. 25, 2002) (return of 30-40% every ten days); *SEC* v. *Texon Energy Corp.*, No. 2:01cv09706 (C.D. Cal. compl. filed Nov. 13, 2001) (return of 12% per year).

There would be a serious gap in investor protection if the court of appeals' decision were allowed to stand and were followed by other courts, thus precluding the Commission from bringing such enforcement actions. As explained above, the phrase "investment contract" was included in the statutory definition of a security as a catch-all for investments that do not fit easily into the other categories listed. The "investment contract" category has served as a critical means of bringing a host of unconventional financial arrangements—offering both fixed and variable returns—within the purview of the federal securities laws. See cases cited at pp. 12, 14-15 n.4, 20-25, *supra*. Excluding such unconventional investments from the scope of the securities laws because they offer a fixed return or are "contractually guaranteed" would be a radical departure from the enforcement history under the Act and would significantly impair the Commission's ability to protect investors from securities fraud. Indeed, the court of appeals' decision provides a recipe for unscrupulous promoters to circumvent the securities laws by describing the returns offered by their investment schemes as fixed or contractually guaranteed amounts.

CONCLUSION

The petition for a writ of certiorari should be granted.

Respectfully submitted.

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FEBRUARY 2003

APPENDIX A

UNITED STATES COURT OF APPEALS
FOR THE ELEVENTH CIRCUIT

No. 01-10107

SECURITIES AND EXCHANGE COMMISSION,
PLAINTIFF-APPELLEE

v.

ETS PAYPHONES, INC., DEFENDANT,
CHARLES E. EDWARDS, DEFENDANT-APPELLANT

Filed: Aug. 6, 2002

Appeal from the United States District Court for the Northern District of Georgia.

Before: EDMONDSON, Chief Judge, and HILL and LAY,* Circuit Judges.

PER CURIAM:

Charles E. Edwards appeals from the district court's grant of a preliminary injunction in favor of the Securities and Exchange Commission (SEC). The SEC alleged Edwards' company, ETS Payphones, Inc. (ETS), sold securities in violation of the registration and anti-fraud provisions of the federal securities laws. *See* 15 U.S.C. §§ 77e(a), 77e(c), 77q(a), 78j(b); 17 C.F.R. § 240.10b-5. The SEC alleged these securities involved

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* Honorable Donald P. Lay, U.S. Circuit Judge for the Eighth Circuit, sitting by designation.

"investment contracts" whereby investors purchased a pay telephone from Edwards only to lease it back to ETS for management in exchange for a fixed monthly fee. The court determined it had jurisdiction over the SEC's action and preliminarily enjoined Edwards from future violations of the securities laws. It also froze Edwards' assets in anticipation of possible future disgorgement. On appeal, Edwards urges that the transactions did not involve securities and that the SEC lacks subject matter jurisdiction. We agree.

Facts

Edwards is the principal actor in several business entities relevant to this appeal. He is the founder and majority stockholder of ETS. He is a member of its board of directors and served as its chief executive officer for most of the time period relevant to this appeal. ETS was incorporated to provide management services, i.e. placement, advertising, maintenance, coin collecting, and accounting, for owners of pay telephones.

Edwards also founded Payphone Systems Acquisitions, Inc. (PSA). PSA was a whollyowned subsidiary of ETS. PSA purchased telephone equipment and locations, which it sold at wholesale to distributors. Edwards also is the principal owner of Twinleaf, Inc., a consulting company Edwards created to provide support services to ETS.

The SEC asserts Edwards used these entities collectively to engage in a single, larger venture involving the sale of securities, specifically investment contracts. An investor would purchase a pay telephone indirectly from PSA, subject to a provision whereby the purchaser had fifteen days to cancel the transaction. Then the purchaser would lease the phone "back" to ETS for

management in exchange for a fixed monthly fee. If at any time the purchaser was not satisfied with the arrangement, it could require ETS to purchase the phone for a prearranged price. Alternatively, it could cancel the lease and repossess its telephone without penalty. The SEC characterizes these transactions collectively as a "unit" sufficient to constitute a security under federal law. There is no dispute that Edwards did not register these transactions with the SEC.[1]

The immediate dispute arose when, in September 2000, ETS and PSA filed a voluntary petition for bankruptcy and reorganization. As a result, ETS stopped making lease payments to the telephone owners and ceased honoring the buyback guarantees. The SEC brought this action asserting Edwards engaged in widespread fraud. Specifically, the SEC alleges Edwards' business venture was actually a "massive Ponzi scheme." It argues Edwards did not operate a legitimate business but rather fleeced his investors by misrepresenting his company as profitable when it only survived because he constantly recruited new purchasers and used their capital to satisfy ETS's obligations. The SEC asserts Edwards sustained this fraud for over five years, raising more than $300 million from over 10,000 investors, with the full knowledge that eventu-

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[1] We note that Edwards conferred with SEC staff in Atlanta in 1995 concerning ETS's payphone program. Edwards and his lawyers provided documents and records to the SEC and met with an SEC attorney. At that time, the record shows the SEC attorney was told the marketing and leasing aspects of ETS's business would be separated to avoid any claim that the payphone business involved a security. The SEC took no action and did not contact Edwards until the year 2000 when ETS filed for bankruptcy and reorganization.

ally the stream of new investors would dry up and only he would profit while his investors lost everything.

To prevent this perceived injustice, the SEC's suit prayed for disgorgement of any profits Edwards may have made as a result of his business dealings. The merits of this suit, however, are not before the court. We only review the district court's grant of a preliminary injunction and freeze of Edwards' assets. Edwards asserts various grounds of error, including an absence of subject matter jurisdiction and abuse of discretion in granting the injunction and asset freeze. We hold the district court lacked subject matter jurisdiction to entertain this action; under the circumstances, we need not consider the other issues.

Jurisdiction

Edwards challenges the district court's subject matter jurisdiction to grant relief to the SEC, arguing the sale of pay telephones does not involve securities under federal law. Specifically, Edwards argues these transactions did not involve investment contracts. In order to defeat a jurisdictional attack on a preliminary injunction, the SEC must establish "a reasonable probability of ultimate success upon the question of jurisdiction when the action is tried on the merits." *SEC* v. *Unique Fin. Concepts, Inc.*, 196 F.3d 1195, 1198 (11th Cir. 1999) (quoting *Majd-Pour* v. *Georgiana Cmty. Hosp., Inc.*, 724 F.2d 901, 902 (11th Cir. 1984)). The Supreme Court has established a three part test for determining whether a particular financial interest constitutes an investment contract and, thus, a security. In *SEC* v. *W.J. Howey Co.*, 328 U.S. 293, 298-99, 66 S. Ct. 1100, 90 L. Ed. 1244 (1946), it held that an investment contract is "a contract, transaction or scheme whereby a person invests his money in a common enterprise and is led to

expect profits solely from the efforts of the promoter or a third party . . . ." Thus, the Supreme Court has characterized a transaction as an investment contract if it involves (1) an investment of money, (2) in a common enterprise, (3) with the expectation of profits to be derived solely from the efforts of others. We agree with the district court that an investment of money is apparent. We address the remaining requirements in turn.

A. Common Enterprise

As Edwards points out, there is disagreement among the circuits as to the requirements of the second prong of the *Howey* test. Most circuits that have considered the issue find it satisfied where a movant shows "horizontal commonality," that is the "pooling" of investors' funds as a result of which the individual investors share all the risks and benefits of the business enterprise. *See, e.g., SEC* v. *Infinity Group Co.*, 212 F.3d 180, 188 (3d Cir. 2000).[2]

Edwards asserts the test for a common enterprise in this circuit is not settled and urges the court to adopt horizontal commonality. Notwithstanding Edwards' argument, we believe we are bound by precedent to apply a different test for commonality, "broad vertical commonality." *See SEC* v. *Unique Financial Concepts, Inc.*, 196 F.3d 1195, 1199-1200 (11th Cir. 1999); *Eberhardt* v. *Waters*, 901 F.2d 1578, 1580-81 (11th Cir. 1990); *SEC v. Koscot Interplanetary, Inc.*, 497 F.2d 473, 478-79 (5th Cir. 1974). Broad vertical commonality, the

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[2] *See also SEC* v. *Banner Fund Int'l*, 211 F.3d 602, 614-15 (D.C. Cir. 2000); *SEC* v. *Life Partners, Inc.*, 87 F.3d 536, 543-45 (D.C. Cir. 1996); *Teague* v. *Bakker*, 35 F.3d 978, 986 n.8 (4th Cir. 1994); *Wals* v. *Fox Hills Dev. Corp.*, 24 F.3d 1016, 1018-19 (7th Cir. 1994); *Revak* v. *SEC Realty*, 18 F.3d 81, 87-89 (2d Cir. 1994); *Newmyer* v. *Philatelic Leasing, Ltd.*, 888 F.2d 385, 391-93 (6th Cir. 1989).

easiest to satisfy of the alternative tests, only requires a movant to show that the investors are dependent upon the expertise or efforts of the investment promoter for their returns. We need not explore the applicability of this prong to the present case, however, in light of our holding that the last prong, "expectation of profits," clearly is unsatisfied.

B. Expectation of Profits Solely from the Efforts of Others

The SEC cannot show a reasonable probability of success on the merits because it cannot show that investors who contracted with ETS expected profits to be derived solely through the efforts of others.

The SEC argues "profits" must be understood in a general sense. It notes that, in *United Housing Found.* v. *Forman*, 421 U.S. 837, 95 S. Ct. 2051, 44 L. Ed. 2d 621 (1975), the Court stated that an investor is "'attracted solely by the prospects of a return' on his investment." *Id.* at 852, 95 S. Ct. 2051 (quoting *Howey*, 328 U.S. at 300, 66 S. Ct. 1100). The definition of profits, the SEC asserts, must be understood in terms of the nature of an investment. Here, ETS's investors purchased their telephones for the purpose of earning a return on the purchase price. Thus, the SEC urges, this should be enough to justify a finding of expectation of profits.

Although the simplicity of the SEC's proposed approach is naturally appealing, we must disagree. In *Forman*, the Court made clear that the word "profits" has a limited meaning under federal securities law. Profits, in that context, require either a participation in earnings by the investor or capital appreciation. *See id.* at 852, 95 S. Ct. 2051 ("By profits, the Court has meant

either capital appreciation resulting from the development of the initial investment . . . or a participation in earnings resulting from the use of investors' funds . . . ."). In this case, there is no dispute that capital appreciation is not at issue. Moreover, the fixed lease payments paid to owners of the telephones cannot be considered participation in earnings; owners were not looking for any profit in the sense that they would receive earnings from the company. The owners certainly had no intention to share in the concomitant risk that their participation in the company's earnings would occasionally require them to share company losses. Of course, the funds generated by the payphones helped ETS meet its obligations. But this does not justify characterization as participation in earnings. Because the investors received a fixed monthly sum, the actual earnings of their telephone, or ETS, were irrelevant. ETS alone shouldered the risk of its placement of the telephones and ETS alone depended upon the earnings of its business. Thus, only ETS could reap profits as that term is understood under the federal securities law.

Even in the event the investors' return could be considered profits, the final *Howey* prong cannot be satisfied because the investors did not expect profits to be derived solely from the efforts of others. The parties dispute the level of control over the telephones the investors retained under the leaseback agreements. *See Albanese* v. *Florida Nat'l Bank of Orlando*, 823 F.2d 408, 410 (11th Cir. 1987) ("If the investor retains the ability to control the profitability of his investment, the agreement is no security."). The SEC asserts the investors desired their telephones to be passive investments; Edwards urges the investors' right to cancel the

lease and repossess their telephones, or not contract with ETS at all for that matter, constitutes sufficient control under the *Albanese* standard. In our opinion, however, the determining factor is the fact that the investors were entitled to their lease payments under their contracts with ETS. Because their returns were contractually guaranteed, those returns were not derived from the efforts of Edwards or anyone else at ETS; rather, they were derived as the benefit of the investors' bargain under the contract.

Because the SEC cannot satisfy the requirements of the *Howey* test to prove the existence of a security, we hold the district court did not have subject matter jurisdiction under the federal securities laws. The decision of the district court issuing a preliminary injunction and asset freeze is REVERSED with directions to dismiss the SEC's complaint for lack of subject matter jurisdiction.

LAY, Circuit Judge, concurring:

I concur with the judgment set forth in the majority opinion. The SEC cannot carry its burden to prove that Edwards' lease program involved an expectation of profits to be derived solely from the efforts of others. Consequently, there is no investment contract under *SEC* v. *W.J. Howey Co.*, 328 U.S. 293, 66 S. Ct. 1100, 90 L. Ed. 1244 (1946), and no subject matter jurisdiction.

I write separately, however, to state my disagreement with that portion of the opinion which reaffirms broad vertical commonality as the test for common enterprise in the Eleventh Circuit. For the reasons set forth below, I respectfully submit that horizontal commonality is the only valid test for a common enterprise. Moreover, the SEC cannot carry its burden to prove horizontal commonality, and therefore, subject matter jurisdiction also is absent on this basis.

Requiring proof of horizontal commonality is the only logical approach to understanding the concept of a common enterprise. In *Curran* v. *Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 622 F.2d 216 (6th Cir. 1980), the court set forth the widely accepted justification for this position. Proof of horizontal commonality is required because requiring only proof of broad vertical commonality makes *Howey's* third prong-expectation of profits to be derived from the efforts of others-superfluous. *Curran*, 622 F.2d at 221-24 (citing *Milnarik* v. *M-S Commodities, Inc.*, 457 F.2d 274, 275-77 (7th Cir.), cert. denied, 409 U.S. 887, 93 S. Ct. 113, 34 L. Ed. 2d 144 (1972) (Stevens, J.)). "[N]owhere in *Howey* or later Supreme Court decisions is it intimated that ['common enterprise'] is somehow redundant of other elements of the definition of a security." *Id.* at 224 (quoting *Ber-*

man v. Bache, Halsey, Stuart, Shields, Inc., 467 F. Supp. 311, 319 (S.D. Ohio 1979)). Consequently, only a requirement of horizontal commonality is consistent with the *Howey* test for an investment contract.[1] Indeed, in its arguments in a case out of the First Circuit, the SEC concedes that this reasoning is correct and broad vertical commonality is an inappropriate test for *Howey's* common enterprise requirement. *See* Brief for Appellant Securities and Exchange Comm'n at 28 n.11, *SEC* v. *SG Ltd.*, 265 F.3d 42 (1st Cir. 2001) ("The Commission has also long taken the position that broad vertical commonality is not an appropriate test because it collapses the second prong of the *Howey* test (common enterprise) into the third prong (profits to come from the efforts of others).").

The SEC responds that analysis of the present case under a requirement of horizontal commonality is inappropriate, however, because this circuit requires only proof of broad vertical commonality under *SEC* v. *Unique Financial Concepts, Inc.*, 196 F.3d 1195, 1199-1200 (11th Cir. 1999); *Eberhardt* v. *Waters*, 901 F.2d 1578, 1580-81 (11th Cir. 1990); and *SEC v. Koscot Interplanetary, Inc.*, 497 F.2d 473, 478-79 (5th Cir 1974). The

[1] The Sixth Circuit relied a great deal on the decision of the Seventh Circuit in *Milnarik*, 457 F.2d at 274, written by then-Judge Stevens. The *Curran* court, following the reasoning of *Milnarik*, observed:

> [W]e believe that no horizontal common enterprise can exist unless there also exists between discretionary account customers themselves some relationship which ties the fortunes of each investor to the success of the overall venture. Thus in our view the finding of a vertical common enterprise based solely on the relationship between promoter and investor is inconsistent with *Howey*.

Curran, 622 F.2d at 223-24.

majority opinion finds this argument controlling. With all due respect to the law of this circuit, which I am bound to follow as a visiting judge, I must respectfully disagree that this panel is bound by precedent to require only proof of broad vertical commonality.

To the extent the SEC relies on *Unique Financial Concepts* and *Eberhardt*, the SEC's argument is unpersuasive. In these cases, the respective panels relied on a prior panel opinion in *Villeneuve* v. *Advanced Bus. Concepts Corp.*, 698 F.2d 1121 (11th Cir. 1983), for the proposition that the Eleventh Circuit adheres to the broad vertical commonality test. Such reliance is misplaced.[2] The *Villeneuve* panel decision was vacated in an en banc decision. 730 F.2d 1403, 1404 (11th Cir. 1984). The en banc court did not address that part of the panel opinion where the court adhered to the broad vertical commonality test and, thus, did not reinstate the panel's decision in that respect. When the full circuit court vacates a panel decision and hears a case en banc, the panel opinion and judgment are totally vacated and, thus, have no precedential value in whole or in part. *See* 11th Cir. R. 26(k). The only binding authority is the decision of the en banc court and the opinion supporting that decision. *Cf. United States* v. *Rice*, 635 F.2d 409, 410 n. 1 (5th Cir. 1981) (noting that a vacated panel decision "constitutes no precedent"). As such, *Unique Financial Concepts*[3] and *Eberhardt*, er-

[2] The district court in the present case likewise mistakenly relied on the *Villeneuve* panel decision.

[3] It should be noted that, notwithstanding its purported reliance on broad vertical commonality, the *Unique Financial Concepts* court based its decision on the fact that the "investors' funds [were to] be pooled and apportioned proportionately by Appellants

roneously relying on the vacated panel decision in *Villeneuve*, offer no precedent for the proposition that the Eleventh Circuit requires only proof of broad vertical commonality.

The only question concerning the court's authority to require proof of horizontal commonality comes from *Koscot*, a case out of the Fifth Circuit, which arguably binds the court notwithstanding the intervening repudiation of the theory it espoused.[4] *Koscot*, however, is no longer good law and, therefore, we are not bound by it. *See Smith* v. *GTE Corp.*, 236 F.3d 1292, 1303 n.11 (11th Cir. 2001) ("Subsequent panels are not bound by prior decisions where there has been a change in the controlling law as a result of a subsequent . . . Supreme Court decision . . . ."). [5] This court has twice noted-prior to the overruled panel decision in *Villeneuve*-that it "has yet to decide whether *Koscot* and the line of cases following it conflict with *Howey* and [*United Housing Found. Inc.* v. *Forman*, 421 U.S. 837, 95 S. Ct. 2051, 44 L. Ed. 2d 621 (1975)]." *Phillips* v. *Kaplus*, 764 F.2d 807, 816 n.9 (11th Cir. 1985) (citing *Villeneuve*, 730 F.2d at 1404 n.2). I believe that *Koscot* does conflict with *Howey*, per the analysis above, and *Forman*.

In *Forman*, 421 U.S. at 852, 95 S. Ct. 2051, the Supreme Court reiterated that an investment contract re-

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to each account." 196 F.3d at 1200. Thus, the court actually relied on the proofs necessary to show horizontal commonality.

[4] In 661 F.2d 1206, 1209 (11th Cir. 1981) (en banc), this court adopted as binding precedent all decisions of the former Fifth Circuit handed down prior to October 1, 1981.

[5] In fact, in *Long* v. *Shultz Cattle Co., Inc.*, 896 F.2d 85, 88 (5th Cir. 1990), the Fifth Circuit has indicated a willingness to review the vertical commonality test in an appropriate case.

quired "the presence of an investment in a common venture premised on a reasonable expectation of profits to be derived from the entrepreneurial or managerial efforts of others." It also stated, however: "The focus of the [Securities] Acts is on the capital market of the enterprise system: the sale of securities to raise capital for profit-making purposes, the exchanges on which securities are traded, and the need for regulation to prevent fraud and to protect the interest of investors." 421 U.S. at 849, 95 S. Ct. 2051. *Koscot's* broad vertical commonality test, which would include within the purview of a common enterprise even relationships between independent individual "investors" and a single "promoter," is antithetical to the *Forman* Court's notion that the federal securities laws focus on the protection of broader capital markets. Moreover, as discussed in the majority opinion, the *Forman* Court limited the definition of profits to capital appreciation or a participation in earnings. *See id.* at 852. These types of financial return are much more likely to be associated with participation in the broader capital markets where investors' funds are pooled in a single enterprise. In the present case, there was no pooling of money in a common venture; thus, it is my opinion that this case does not fit within *Forman's* understanding of common enterprise.

When the horizontal commonality test is applied to these facts, it is clear that the SEC also cannot carry its burden to show a common enterprise under *Howey*. The SEC asserts horizontal commonality can be found in the fact that Edwards operated a "massive Ponzi scheme." I disagree. The typical Ponzi scheme involves a fraudulent business venture where early investors are paid off by funds obtained from later inves-

tors, rather than the business itself, with the intent of using that early "success" to entice further investment in the sham venture. *See Official Comm. of Unsecured Creditors* v. *R.F. Lafferty & Co., Inc.*, 267 F.3d 340, 343-44 n.1 (3d Cir. 2001) (citing Black's Law Dictionary 1180 (7th ed. 1999)). The fact that a fledgling business uses capital rather than earnings to pay debts, however, does not automatically indicate a Ponzi scheme. It is widely recognized in the commercial world that new businesses often do not show a profit in their early years; the only way to pay debt frequently is through the recruitment of new capital. Thus, it is the nature of the business as a sham which is the crucial consideration. Here, the record indicates that ETS made a good faith effort to run a legitimate business. It dutifully managed the phones it leased for the duration of its existence and continues to do so today under its reorganization plan. At its height, it had offices in twenty-eight states and Mexico and employed 550 people. Neither fact indicates that ETS was a fraudulent enterprise, "[un]supported by any underlying business venture," *see Bald Eagle Area Sch. Dist.* v. *Keystone Fin. Inc.*, 189 F.3d 321, 323 n.1 (3d Cir. 1999) (internal citation omitted), as the SEC would have us believe.

Apart from allegations of a Ponzi scheme, the SEC cannot show horizontal commonality on the facts presented. ETS entered into distinct contracts with each investor; it did not pool their funds. *See Curran*, 622 F.2d at 222 (finding a pooling of investors' interests essential to a finding of common enterprise). The success of one investor's contract had no direct[6] impact on the

[6] The SEC argues all "investors" in ETS shared the risk that it would go bankrupt and become unable to make lease payments; thus, it argues they are all "intertwined." This argument should be rejected as casting far too broad a net, contrary to the Court's teaching in *United Housing Found.* v. *Forman*, 421 U.S. 837, 857 n.24, 95 S. Ct. 2051, 44 L. Ed. 2d 621 (1975) (stating that mere "risk of insolvency . . . 'differ[s] vastly' from the kind of risk of 'fluctuating' value associated with securities investments") (internal citation omitted).

success of any other; the investors were not "inextricably intertwined." *SEC* v. *SG Ltd.*, 265 F.3d 42, 52 (1st Cir. 2001); *Union Planters Nat'l Bank of Memphis* v. *Commercial Credit Bus. Loans, Inc.*, 651 F.2d 1174, 1183 (6th Cir. 1981). The investors were entitled to a guaranteed lease payment; only ETS bore the risk of failure and it alone would have enjoyed the benefits had its business prospered. Every indication is that there was no horizontal commonality inherent in Edwards' lease program. Consequently, subject matter jurisdiction fails on this basis as well.

APPENDIX B

UNITED STATES DISTRICT COURT FOR THE
NORTHERN DISTRICT OF GEORGIA

No. Civ. A. 1: 00-CV2532JTC

SECURITIES AND EXCHANGE COMMISSION,
PLAINTIFF

v.

ETS PAYPHONES, INC.,
AND CHARLES E. EDWARDS, DEFENDANT

Filed: Nov. 20, 2000

ORDER

CAMP, District Judge.

This case is before the Court on Plaintiff Securities and Exchange Commission's Motion for Preliminary Injunction [# 3-1].

I. PROCEDURAL BACKGROUND

The Security and Exchange Commission ("Commission") brings this suit against ETS Payphones, Inc. and Charles E. Edwards for fraudulent and unregistered offering of securities in violation of the registration and anti-fraud provisions of the federal securities laws and seeks injunctive and other relief. Defendant ETS, who has filed for bankruptcy protection, consented to the injunction without admitting Plaintiff's allegations. Defendant Edwards, however, contends that (1) the

sale/leaseback of pay telephones does not constitute a security; (2) the Commission is not entitled to an injunction because Defendant Edwards is not likely to continue selling these securities; and (3) the asset freeze sought by the Commission upon Defendant Edwards is unwarranted.

The Court finds that the Commission has produced sufficient evidence to support an injunction and makes the following findings of fact and conclusions of law:

II. FINDINGS OF FACT

ETS Payphones, Inc. ("ETS") is a Georgia Corporation founded by Charles E. Edwards ("Edwards") in October 1994. For the past five years, ETS has offered and sold coin-operated telephones in units including a telephone, site lease, lease/back agreement, and buy/back agreement. An investor will pay $6,750.00 to ETS for a pay telephone, and ETS leases the telephone back from the investor for a fixed fee. The investor can, at his option, require ETS to repurchase the equipment at the end of the lease period or upon 180 days notice. Under the lease agreement, investors retain little, if any, control. Instead, Defendant manages, maintains, and operates the pay phones.

ETS offered and sold these investments to the general public through distributors and sales forces made up largely of licensed insurance agents. In their marketing efforts, ETS and its distributors used the mail and means such as internet websites to market the investments. However, ETS has not registered the sales as securities pursuant to the Securities Acts.

ETS advertised in sales literature that portrayed the company and its officials as experienced and successful in the telephone industry. Marketing brochures dis-

cussed the "profitability" of payphones and encouraged investors to "watch the profits add up." (Pl.'s Ex. 17). ETS websites noted the "profitable" opportunities for investors, and distributors offered individuals a fixed annual return of 14.1% on investments. (Pl.'s Ex. 22, 24).

Unfortunately for investors, these brochures, advertisements and websites failed to disclose the financial condition of the company. In reality, ETS always lost money on its payphone operations. In the first six months of this year, ETS lost more than $33 million. (Pl.'s Ex. 1). Similarly, from November 1998 to March 1999, ETS had an operating loss of $32 million. (Pl.'s Ex. 4). Because revenue from payphone operations never covered operating expenses, ETS had to attract an ever expanding number of investors to meet its obligations to existing investors. However, none of this information was disclosed. Instead, ETS continued to advertise the "profitability" of pay telephones, emphasizing the opportunities for investors to "watch the profits add up." (Pl.'s Ex. 17).

Despite these losses, Edwards continued to personally profit from the operation, receiving $2.24 million in compensation from ETS and Twinleaf, Inc. between 1998 and 2000. (October 12, 2000, Hearing Tr., pp. 68-69). He currently owns real estate worth more than $7 million. Similarly, a number of wholly owned subsidiaries also profited from ETS. From November 1998 to March 1999, ETS paid $3 million in management fees to an affiliated company owned by Edwards. (Pl.'s Ex. 4, Note H). Moreover, ETS financial statements indicate that the company transferred more than $11.6 million in interest free loans to companies controlled by Edwards. (Pl.'s Ex. 2, 4).

As owner/operator of ETS, Edwards directed company affairs, contracted with distributors to market telephone units, reviewed sales literature, and understood the true financial condition of the company. On September 11, 2000, ETS Payphones, Inc. filed for bankruptcy.

III. CONCLUSIONS OF LAW

To obtain an injunction under Section 20(b) of the Securities Act of 1933 and Section 21(d) of the Securities and Exchange Act of 1934, the Commission must establish the following: (1) a prima facie case of previous violations of federal securities laws, and (2) a reasonable likelihood that the wrong will be repeated. *See SEC* v. *Unique Financial Concepts, Inc.*, 196 F.3d 1195, 1199 n.2 (1999).

A. Prima Facie Case

Section 2(a)(1) of the Securities Act and Section 3(a)(10) of the Exchange Act define a "security" to include an "investment contract." *See* 15 U.S.C. § 77b(a)(1) and 78c(a)(10) (1997). An investment contract is "a contract, transaction or scheme whereby a person invests his money in a common enterprise and is led to expect profits solely from the efforts of the promoter or a third party." *SEC* v. *W.J. Howey Co.*, 328 U.S. 293, 298-99, 66 S. Ct. 1100, 1103, 90 L. Ed. 1244 (1946). The Eleventh Circuit has divided the *Howey* test into three elements: "(1) an investment of money; (2) a common enterprise; and (3) the expectation of profits to be derived solely from the efforts of others." *Villeneuve* v. *Advanced Business Concepts Corp.*, 698 F.2d 1121, 1124 (11th Cir. 1983*), aff'd en banc*, 730 F.2d 1403 (11th Cir. 1984). For purposes of this case, only the second and third elements merit discussion.

1. Common Enterprise

In order to satisfy the second element of the *Howey* test, the Commission must establish that individuals invested money in a "common enterprise." A common enterprise exists where "the fortunes of the investor are interwoven with and dependant on the efforts and success of those seeking the investment or of third parties." *SEC* v. *Unique Financial Concepts, Inc.*, 196 F.3d 1195, 1199 (11th Cir. 1999) (quoting *Villeneuve*, 698 F.2d at 1124). The thrust of this test is that "investors have no desire to perform the chores necessary for a return." *Id.* at 1200 (quoting *Eberhardt* v. *Waters*, 901 F.2d 1578, 1580-81 (11th Cir. 1990)). Instead, "the requisite commonality is evidenced by the fact that the fortunes of all investors are tied to the efficacy of the promoter." *Id.* (quoting *SEC* v. *Koscot Interplanetary, Inc.*, 497 F.2d 473, 479 (5th Cir. 1974)). Because emphasis is placed upon the relationship between the investors and the promoter, this concept is referred to as "vertical commonality."

Defendant argues that other courts have defined "common enterprise" as one which requires investors to share or pool funds in order to succeed in a venture. *See Revak* v. *SEC Realty Corp.*, 18 F.3d 81, 87-88 (2d Cir. 1994); *Stenger* v. *R.H. Love Galleries, Inc.*, 741 F.2d 144 (7th Cir. 1984); *Newmyer* v. *Philatelic Leasing, Ltd.*, 888 F.2d 385, 394 (6th Cir. 1989). Under this definition, plaintiffs must demonstrate that the fortunes of individual investors are "inextricably intertwined by contractual and financial arrangements to that of any other investors." *Cooper* v. *King*, No. 95-00289, 1997 WL 243424 at *2 (6th Cir. May 9, 1997). This concept is referred to as "horizontal commonality." Defendant's

scheme may amount to "horizontal commonality," but that is not the definition this court must apply.[7]

In this case, investors' fortunes are inextricably tied to Defendant Edwards and ETS. Investors purchase a pay phone for $6,750, lease it back to ETS, and receive a monthly payment as a return on their investment. They have no control over the pay phone and do not participate in its operation. Instead, Defendant manages and maintains the pay phone, offering to repurchase it upon termination of the lease. Recovery of this investment, however, depends upon the financial viability of the company and Defendant's ability to generate a profit. Therefore, the fortunes of investors are linked to the efficacy of the promoter. This program satisfies the common enterprise element of an investment contract.

2. Expectation of Profits

In order to satisfy this element of the *Howey* test, Plaintiff must establish that investors expect profits to be derived "solely from the efforts of the promoter or third party." *Howey*, 328 U.S. at 299, 66 S. Ct. at 1103. If the investor controls the profitability of his investment, the agreement is not a security. Therefore, the "crucial inquiry is the amount of control that the investors retain under their written agreements." *Albanese*

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[7] Unfortunately, neither definition of "common enterprise" adequately addresses the purpose of the federal securities laws—to protect potential and actual investors from fraud. A broader definition of commonality should protect individual investors who rely solely on the "efficacy" of the promoter, as well as multiple investors who "pool" their funds in order to share the risks and profits. *See* Marc G. Alcser, *The Howey Test: A Common Ground for the Common Enterprise Theory*, 29 U.C. Davis L. Rev. 1217 (1996).

v. *Florida Nat'l Bank of Orlando*, 823 F.2d 408, 410 (11th Cir. 1987). In *Albanese*, investors purchased an ice machine, leased it back to the company, and received a monthly return on investment. The company managed, maintained, serviced and operated the machines. Investors, however, were allowed to select the locations of the machines. *Id.* at 410.

The Eleventh Circuit concluded that this enterprise satisfied this element of the *Howey* test because investors expected profits to be derived solely from the efforts of others. While investors retained some control over their machines, this control was "insubstantial" and "illusory" because (1) the power to specify locations was limited to sites already procured by the corporation; (2) the corporation offered its expertise in finding locations, contracting with hotels, servicing the machines, and accounting for profits; and (3) the investors had no realistic alternative to allowing the corporation to manage their investments. *Id.* at 412; *see also*, *Unique Financial Concepts*, 196 F.3d 1195, 1201 (concluding that investors had no control over their investments and that profits were derived by defendant corporation under "any reasonable interpretation of 'solely'").

In this case, Defendants monitored, managed, and maintained the pay telephones assigned to investors. After contributing money, Plaintiffs had little, if any, involvement in the enterprise. Any control that Plaintiffs may have retained was "illusory" or "insubstantial" because Defendants assumed all responsibility for the payphones. Investors never saw the telephones, never used the telephones, and often did not know where they were located. Because profits were derived "solely"

from the efforts of the Defendant, the lease agreement satisfies the third element of an investment contract.

4. Violations

Since Defendant's payphone program is an investment contract, it is governed by the Securities and Exchange Acts. Section 5(c) of the Securities Act, 15 U.S.C. § 77e(a)(2), makes it unlawful to offer to sell a security for which a registration statement has not been filed. Similarly, Section 5(a) of the Securities Act, 15 U.S.C. § 77e(a)(3), makes it unlawful for persons to use any means or instruments of transportation or communication in interstate commerce or of the mails to sell a security for which a registration statement is not in effect. Thus, Defendants have sold unregistered securities to thousands of people in thirty-eight states for the last five years. In order to make these transactions, Defendants used the mails and other forms of media, including internet websites. These activities constitute prima facie violations of Sections 5(a) and 5(c) of the Securities Act. *SEC* v. *Continental Tobacco Co.*, 463 F.2d 137, 155 (5th Cir. 1972).

Furthermore, Section 17(a) of the Securities Act and Section 10(b) of the Exchange Act proscribe fraudulent conduct in connection with the offer, purchase and sale of securities. *See* 15 U.S.C. § 77q(a) and 15 U.S.C. 78j(b). To establish a violation of these provisions, the Commission must show that Defendants (a) used jurisdictional means; (b) engaged in fraudulent schemes, practices or courses of business or made materially false or misleading statements; (c) in connection with the offer or sale of securities; and (d) for violations of Section 17(a)(1) and 10(b), acted with scienter. *Steadman* v. *SEC*, 603 F.2d 1126, 1131-33 (5th Cir. 1979), *aff'd*, 450 U.S. 91, 101 S. Ct. 999, 67 L. Ed. 2d 69 (1981).

Here, Defendant Edwards used the mails (to send promotional sales materials to distributors and investors) and instrumentalities of interstate commerce (e.g., an Internet web site to provide sales materials) in connection with the offer or sale of securities. Such activity satisfies the jurisdictional means requirement. *See Glick* v. *Campagna*, 613 F.2d 31, 35-36 (3d Cir. 1979).

Moreover, Defendant failed to adequately inform investors of the financial condition of the company. Investors were not told: (1) that ETS had failed to make a profit; (2) that ETS was losing money on its payphone program; and (3) that ETS depended on funds from new investors in order to sustain operations. Instead, investors were led to believe that both ETS and its payphone program generated a profit. These misrepresentations and omissions are material because they go to the essence of the investment decisions made by individual investors. *See Basic Inc.* v. *Levinson*, 485 U.S. 224, 231-32, 108 S. Ct. 978, 983, 99 L. Ed. 2d 194 (1988) (determining that information is material and must be disclosed if there is a substantial likelihood that "the disclosure of the omitted facts would have been viewed by the reasonable investors as having significantly altered the 'total mix' of information made available.").

Finally, the Supreme Court has defined scienter as "a mental state embracing intent to deceive, manipulate, or defraud." *Ernst & Ernst* v. *Hochfelder*, 425 U.S. 185, 193 n. 12, 96 S. Ct. 1375, 1381 n.12, 47 L. Ed. 2d 668 (1976). In the Eleventh Circuit, scienter may be shown by "severe recklessness," defined as "those highly unreasonable omissions or misrepresentations that involve not merely simple or even inexcusable negligence, but an extreme departure from the standards of ordinary care, and that present a danger of misleading

buyers or sellers which is either known to the defendant or is so obvious that the defendant must have been aware of it." *McDonald* v. *Alan Bush Brokerage Co.*, 863 F.2d 809, 814 (11th Cir. 1989).

The misrepresentations and omissions made by Defendant amount to severe recklessness. Defendant was aware of the financial condition of ETS and the fact that ETS relied solely on funds from new investors in order to sustain operations. Despite this knowledge, Defendant marketed the program as a profitable enterprise "ringing with opportunity."

B. Reasonably Likely to Continue These Violations

In order to obtain a preliminary injunction, the Commission must also show that Defendant Edwards is reasonably likely to continue violating the securities laws. *See Unique Financial Concepts*, 196 F.3d at 1199 n. 2; *SEC* v. *Int'l Heritage, Inc.*, (Story, J) (concluding that an injunction is warranted if there is a "reasonable likelihood that Defendants are engaged or are about to engage in practices that violate federal securities law").

Analysis of a number of factors determines the likelihood of future violations. Courts must consider "the egregiousness of the defendant's actions, the isolated or recurrent nature of the infraction, the degree of scienter involved, the sincerity of the defendant's assurances against future violations, the defendant's recognition of the wrongful nature of his conduct, and the likelihood that the defendant's occupation will present opportunities for future violations." *Id.* Courts place special emphasis on "proof of past substantive violations that indicate a reasonable likelihood of future substantive violations." *Id.*

The evidence in this case supports Plaintiff's request for a preliminary injunction. First, Defendant's actions were egregious in operating an investment scheme at a significant loss while only he profited. While the company lost millions, Defendant sponsored a NASCAR racing team, purchased a home on Sea Island, and received $700,000 in "consultant" fees from another payphone enterprise.

Second, Defendant's occupation presents opportunities for future violations. Defendant operates a number of wholly owned subsidiaries created to support, supplement, and develop the ETS pay phone enterprise. Because these companies may contain funds (in the form of loans) which are rightfully owned by ETS investors, a preliminary injunction is necessary to prohibit Defendant from using these subsidiaries to market similar investment programs.

Finally, Defendant acted with scienter because he knew that his conduct might violate securities laws. Over the past eighteen months Defendant received cease and desist order from courts in North Carolina, Kansas, and Rhode Island. Despite these warnings, Defendant continued to operate this enterprise. Because Defendant's conduct was egregious, systematic, and continuous for a number of years, a preliminary injunction is warranted.

C. Asset Freeze

The purpose of an asset freeze is to insure that any funds which may become due can be collected. *SEC* v. *Unifund SAL*, 910 F.2d 1028, 1041 (2d Cir. 1990). In order to obtain an asset freeze, the Commission must show that it is likely to succeed on the merits of its claim. *SEC* v. *Cavanagh*, 155 F.3d 129, 132 (2d Cir. 1998). As stated in Part II of this Order, that standard has been met.

ETS, under Edward's control, engaged in the unregistered sale of securities in violation of federal law. Edwards profited from this enterprise, receiving approximately $15 million in the form of interest free loans and fees to companies that he owns. Edwards also received $2.24 million in compensation from Twinleaf and ETS, and currently owns real estate valued at $7 million. In order to preserve secure assets for disgorgement if it becomes appropriate, an asset freeze of Defendant Edwards' assets is necessary.

IV. CONCLUSION

For the foregoing reasons, Plaintiff's Motion for a Preliminary Injunction and Asset Freeze [# 3-1] is **GRANTED**.

APPENDIX C

UNITED STATES COURT OF APPEALS
FOR THE ELEVENTH CIRCUIT

No. 01-10107-DD

SECURITIES AND EXCHANGE COMMISSION,
PLAINTIFF-APPELLEE

v.

CHARLES E. EDWARDS, DEFENDANT-APPELLANT

On Appeal from the United States District Court
for the Northern District of Georgia

[Filed: Nov. 15, 2002]

ON PETITION(S) FOR REHEARING AND PETITION(S) FOR REHEARING EN BANC
(Opinion _____, 11th Cir., 19_____, _____F.2d_).

Before: EDMONDSON, Chief Judge, HILL and LAY, Circuit Judges.

PER CURIAM:

The petition(s) for Rehearing are DENIED and no Judge in regular active service on the Court having requested that the Court be polled on rehearing en banc

(Rule 35, Federal Rules of Appellate Procedure), the Petition(s) for Rehearing En Banc are DENIED.*

Entered for the Court:

/s/ (Illegible)
CHIEF JUDGE

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* Honorable Donald P. Lay, U.S. Circuit Judge for the Eighth Circuit, sitting by designation.

APPENDIX D

STATUTORY APPENDIX

1. Section 77b(a) of Title 15 of the United States Code provides in relevant part:

When used in this subchapter, unless the context otherwise requires—

> (1) The term "security" means any note, stock, treasury stock, security future, bond, debenture, evidence of indebtedness, certificate of interest of participation in any profit-sharing agreement, collateral-trust certificate, preorganization certificate or subscription, transferable share, investment contract, voting-trust certificate, certificate of deposit for a security, fractional undivided interest in oil, gas, or other mineral rights, any put, call, straddle, option, or privilege on any security, certificate of deposit, or group or index of securities (including any interest therein or based on the value thereof), or any put, call, straddle, option, or privilege entered into on a national securities exchange relating to foreign currency, or, in general, any interest or instrument commonly known as a "security", or any certificate of interest of participation in, temporary or interim certificate for, receipt for, guarantee of, or warrant or right to subscribe to or purchase, any of the foregoing.

2. Section 78c(a) of the United States Code provides in relevant part:

When used in this chapter, unless the context otherwise requires—

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> (10) The term "security" means any note, stock, treasury stock, security future, bond, debenture, certificate of interest or participation in any profit-sharing agreement or in any oil, gas, or other mineral royalty or lease, any collateral-trust certificate, preorganization certificate or subscription, transferable share, investment contract, voting-trust certificate, certificate of deposit for a security, any put, call, straddle, option, or privilege on any security, certificate of deposit, or group or index of securities (including any interest therein or based on the value thereof), or any put, call, straddle, option, or privilege entered into on a national securities exchange relating to foreign currency, or in general, any instrument commonly known as a "security"; or any certificate of interest or participation in, temporary or interim certificate for, receipt for, or warrant or right to subscribe to or purchase, any of the foregoing; but shall not include currency or any note, draft, bill of exchange, or banker's acceptance which has a maturity at the time of issuance of not exceeding nine months, exclusive of days of grace, or any renewal thereof the maturity of which is likewise limited.